First Trust
Monday Morning OUTLOOK

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A Generation of Interest Rate Illiterates

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An entire generation of investors has been misled about interest rates: where they come from, what they mean, how they're determined.

Lots of this confusion has to do with the role of central banks. Many think central banks, like the Fed, control all interest rates. This isn't true. They can only control short-term rates. It's true these can have an impact on other rates, but it doesn't mean they control the entire yield curve.

Ultimately, an interest rate is simply the cost of transferring consumption over time. If someone wants to save (spend less than they earn today) in order to consume more in the future, they must find someone else who wants to spend more today than they earn, and then repay in the future.

Savers (lenders) want to be compensated by maintaining - or improving - their future purchasing power, which means they need payment for three things: inflation, credit risk, and taxes.

Lenders deserve compensation for inflation. Credit risk – the chance a loan will not be repaid – is also part of any interest rate. And, of course, those who earn interest owe taxes on that income. After taxes, investors deserve a positive return. In other words, interest rates that naturally occur in a competitive marketplace should include these three factors.

So, why haven't they? In July 2012, the 10-year Treasury yield averaged just 1.53%. But since then, the consumer price index alone is up 1.5% per year. An investor who paid a tax rate of 25% would owe roughly 0.375% of the 1.53% yield in taxes. In other words, after inflation and taxes (and without even thinking about credit risk, which on a Treasury is essentially nil), someone who bought a 10-year bond in July 2012 has lost 0.35% of purchasing power each year, in addition to capital losses as bond prices have declined.

Something is off. The bond market has not been compensating investors for saving, it has been punishing them.

Some blame Quantitative Easing. The theory is that when the Fed buys bonds, yields fall. It's simply supply and demand. But this is a mistake. Bonds aren't like commodities, where if someone buys up all the steel, the price will move higher. A bond is a bond, no matter how many exist. Just because Apple has more bonds outstanding than a small cap company doesn't mean Apple pays a higher interest rate.

If the Fed bought every 10-year Treasury in existence except for a single $10,000 Note, why would its yield be less than the current yield on the 10-year note (putting aside artificial government rules that goad banks into buying Treasury securities)? It's the same issuer, same inflation rate, same tax rate, same credit risk, and the same maturity and coupon. It should have the same yield. It didn't become a collector's item; it still faces competition from a wide array of other investments. It's still the same bond.

The real reason interest rates have remained so low is because many think the Fed will keep holding short-term rates down below fundamental levels well into the future. If the Fed promises to hold the overnight rate at zero for 2-years then the 2-year Treasury will also be close to zero. And since the 10-year note is made up of five continuous 2-year notes, then Fed policy can influence (but not control) longer-term yields as well. The Fed's zero percent interest rate policy artificially held down longer-term Treasury yields, not Quantitative Easing. That's why longer-term yields have risen as the Fed has hiked rates.

And they will continue to rise. Why? Because the Fed has held short-term rates too low for too long. Interest rates are below inflation and well below nominal GDP growth. The Fed has gotten away with this for quite some time because they over-regulated banks, making it hard to lend and grow. Those days are ending and low rates now are becoming dangerous.

With inflation and growth rising, and regulation on the decline, interest rates must go higher. It's true the Fed is unwinding QE, but that's not why rates are going up. They're going up because the economy is telling savers that they should demand higher rates.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-10 / 7:30 am	PPI – Mar	+0.1%	**+0.1%**		+0.2%
7:30 am	"Core" PPI – Mar	+0.2%	**+0.2%**		+0.2%
4-11 / 7:30 am	CPI – Mar	0.0%	**0.0%**		+0.2%
7:30 am	"Core" CPI – Mar	+0.2%	**+0.2%**		+0.2%
4-12 / 7:30 am	Initial Claims – Apr 7	230K	**229K**		242K
7:30 am	Import Prices – Mar	+0.1%	**-0.1%**		+0.4%
7:30 am	Export Prices – Mar	+0.1%	**0.0%**		+0.2%
4-13 / 9:00 am	U. Mich Consumer Sentiment- Apr	100.4	**101.4**		101.4

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.